The Franchised Dealer
The Economic and Statutory Framework
2009

While the first automakers initially sold cars directly to the public, they soon outsourced the costs of retailing. Simply put, the goal of the manufacturer is to use the dealer body to externalize all of the costs associated with selling and servicing vehicles. Absent the franchised dealers, a manufacturer would have to invest billions of dollars to replicate the existing facilities, employees, and retail presence. Moreover, no manufacturer would want to assume the risk involved with retailing. For example, if the manufacturers make an unappealing vehicle, the dealers bear the brunt of that mistake, because the dealers buy the vehicles from the manufacturers and suffer the consequences of unsold inventory. Similarly, the dealers also bear the risk of the deterioration of a prime real estate location and the risk of a local economic downturn.

What is the nature of the contractual relationship between the automobile dealer and the manufacturer?

Dealers operate under a "Dealer Sales and Service Agreement" commonly referred to as a franchise agreement, whereby the dealers are required to operate under a "marketing plan or system" substantially prescribed by the manufacturer. These Agreements also authorize manufacturers to decide the quantity and quality of the facilities, and the machinery and labor resources to be used by the dealer. In addition, they grant a wide range of decision rights. In particular, manufacturers hold extensive interpretation, implementation and enforcement powers. For example, the contracts generally allow manufacturers to produce the sales targets and to determine sanctions for non-performing dealers. Moreover, they may adapt the contract to new technological circumstances by deciding, for example, to begin selling vehicles directly to consumers via the internet. While contracts describe the duties of dealers in detail, those of manufacturers are described vaguely, so that they enjoy substantial discretion.

These Agreements and related side agreements require the dealer to make investments in land, buildings, equipment, computers, tools, personnel, training, advertising and promotions, and good will. Additionally, dealers are required to maintain extensive inventories of new and used vehicles (and often manufacturer certified used cars), and parts. The manufacturer controls the only source of new vehicle inventory and may influence a large portion of the dealers' used inventory.

Also, the manufacturer sets labor repair rates and time constraints on warranty work, and the manufacturer has the right to conduct surprise warranty audits and immediately charge a dealer for overcharges. Manufacturers increasingly rely on incentive programs to market vehicles. Such monies are also subject to audit and represent yet another cost shifting to dealers since dealer incentive monies are typically paid at the end of a program and not when the vehicle is sold. Each dealer has an "open account" with the manufacturer which they can use to instantly assess charges against the dealer. It's like the manufacturer has the dealer's checkbook. Increasingly,

manufacturers are using the multiple points of leverage in this relationship to force dealers to make multi-million dollar facilities upgrades or take unwanted vehicles into inventory regardless of local demand.

Most significantly, no individual dealer, regardless of size, has the opportunity to negotiate any of the terms and/or conditions of the agreement. All of these factors, combined with the limited opportunity to switch manufacturers, the high cost of making any such change, and the difficulty of converting expensive facilities to another use make, the franchise agreement a classic "take it or leave it" contract of adhesion.

A second component of the contractual technology is a monitoring and evaluation mechanism that allows manufacturers both to assess dealers' performance and to ensure their compliance with these vertical restraints. Manufacturers are also allowed to unilaterally set targets that dealers must attain, both in terms of sales and in customer satisfaction (as measured by customer surveys). Even though the measurement of customer satisfaction is difficult to verify by third parties, constructing monetary incentives which link price discounts to the level of service are commonplace. Decision rights on the performance benchmarks are left entirely in the hands of the manufacturer. Little exists in the contracts to constrain the ability of manufacturers to cheat when setting or revising objectives. The extent to which these targets are met is the crucial variable determining dealers' compensation.

Manufacturer restrictions on after-sale service aim to control the quality of after sale services provided by dealers. First, dealers are subject to manufacturers' directions concerning the machines and tools necessary to provide maintenance and repair services. They must hire enough well-trained personnel to deliver the after-sale services and must send their own employees to training workshops organized by the manufacturer at the dealer's expense. Moreover, manufacturers determine the organization and dimension of the service area where this service is delivered. Finally, in all contracts, dealers undertake the obligation to keep a minimum stock of spare parts, in order to avoid delays in after-sale services. Most manufacturers retain discretion in determining this stock.

The asymmetry that characterizes the assignment of decision rights to the parties is present in all phases of the Agreement. Not only do manufacturers assume the role of policing the relation and completing the Agreements, but their obligations are less specified. Moreover, there are no contractual enforcement mechanisms, apart from state laws or regulations, to punish their non-performance.

Why were Federal and State laws enacted to govern the specific relationship between automakers and the dealers?

There is an economic power imbalance between the manufacturer and the dealer that has persisted from the early days of the franchise system to the present. Prior to the enactment of statutory provisions that provide a safety net of equity, existing dealers faced several types of pressure from the manufacturers: the threat of a unilateral termination without cause; the threat that the manufacturer would unilaterally establish

additional competing dealerships with the same brand on every corner; and demands from manufacturers to purchase unneeded vehicles and products.

Outside of the legislative process, can the dealers work together to achieve a collective result in negotiations with the manufacturers?

Absolutely not. The United States Justice Department, the Federal Trade Commission, and the various state Attorneys General would view any attempt by a dealer body to exercise collective economic power with respect to its manufacturer as a classic violation of antitrust law. (This is to be contrasted with labor unions which are expressly exempted from the application of the antitrust laws by the national labor laws that establish the rules for collective bargaining and the like. Thus, unlike the UAW, Ford dealers, for example, cannot collectively refuse to deal with Ford (i.e., strike) if the dealers believe that Ford is establishing too many Ford dealerships or feel that Ford is otherwise treating them unfairly.) In the face of (1) years of arbitrary treatment, (2) the failure of the judicial branch, at the time, to recognize a distinct cause of action, and (3) the limitations imposed by the antitrust laws, the dealers sought the only other relief available – the legislative process.

Overview of Proposed Statutory Changes

Colorado law establishes the fact that regulating automobile sales falls within the State's general police power. Consequently, Colorado has enacted franchise laws to protect consumers from potential fraud, to protect local dealers from vertical integration under circumstances where manufacturers hold disproportionate market power over dealers, and to connect consumers with dealers who serve as their best chance for a trustworthy and long-term relationship. Following are the areas in existing statutory law need to be added in view of the current manufacturer-dealer environment.

1. Eliminate a manufacturer's use of "exclusive facility" requirements unless their use is reasonable.
2. Requirement that a manufacturer compensate a franchised dealer for their time spent diagnosing warranty claims and pay for warranty work and service loaner vehicles at the prevailing rate charged the general public and not a rate determined by the manufacturer.
3. Establish a 12 month statute of limitations for a manufacturer audit of a dealer's warranty claims and sales incentives, except in the case of fraudulent claims.
4. Prohibit a manufacturer from using, or threatening to use, an audit of a dealer in order to coerce a dealer to forego any rights otherwise granted under the franchise agreement.
5. Prohibit a manufacturer from exercising a right of first refusal or refusing the sale or assignment of their ownership, unless they can show the transferee unfit.
6. Prohibit a manufacturer from controlling executive management of a dealer, unless they can show the executive management to be unfit.
7. Prohibit a manufacturer from conditioning the renewal or extension of a franchise on facility improvements, unless the manufacturer can show the reasonableness of such a demand in view of the public and economic circumstances, and to require

the manufacturer, in writing, to provide a dealer with adequate inventory to support the increased overhead associated with the facility improvements.